Mexico's Crisis: Looking Back To Assess the Future

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It may take several years for Mexico to fully regain the investor confidence lost during this recent economic crisis. However, the speed with which Mexico recovers will be fundamentally determined by the economic policies it chooses to follow. The more Mexico relies on open markets and stable macroeconomic policies, and the less it withdraws within itself, the faster the country will recover.

In early December 1994, the Organization for Economic Cooperation and Development (OECD) and many private economists were predicting that Mexico's real gross domestic product (GDP) would grow by at least 3.8 percent in 1995.[1] Mexico appeared to be on the fast track to economic growth and stability. For the first time in many years, its annual inflation rate was down to less than 10 percent, the public-sector budget was nearly balanced, and exports were growing at an annual rate in excess of 22 percent. Moreover, Mexico's entry into the North American Free Trade Agreement (NAFTA) and its recent uneventful presidential elections suggested a continuity in the country's economic reform policies.

A few weeks later, however, on December 20, 1994, international financial markets were rocked by the devaluation of the Mexican peso. Then, what first appeared to be a minor correction in Mexico's nominal exchange rate quickly developed into a broader financial crunch felt in and outside Mexico. By March 1995, the peso had fallen more than 50 percent against the dollar, and monthly inflation was growing at an annual rate in excess of 60 percent. Despite a $50 billion financial assistance package arranged in late January by the international community to help shore-up liquidity problems in Mexican dollar-denominated debt, interest rates on this debt remained twice as high as they were before the devaluation. The Mexican government now expects the country's real GDP to fall about 3 percent in 1995.

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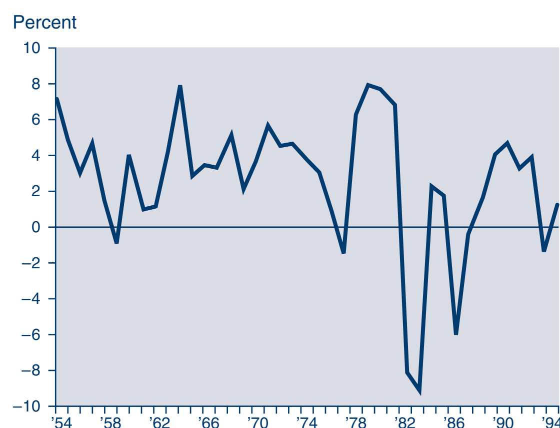
Figure 1
Annual Growth Rate of Mexican Real Gross Domestic Product per Capita, 1954–94



SOURCES: Penn World Table, Version 5.6, 1995; International Monetary Fund.

to follow. The more Mexico relies on open markets and stable macroeconomic policies, and the less it withdraws within itself, the faster the country will recover.

The purpose of this article is to put Mexico's most recent economic crisis into broad historical context in order to assess the future trend in Mexico's economic policies. Like many developing countries during the 1980s, Mexico's economic paradigm shifted from a closed market, inward-looking development strategy to an open market, outward-oriented development strategy. Unlike the period leading up to the 1982 debt crisis, the period before the latest crisis was one in which markets were becoming more open, inflation was low, and the public-sector budget was nearly balanced. Although there are forces in Mexico pulling away from market reforms as well as toward them, the trend in Mexico's policies has been toward greater openness. These economic reform policies have made future openness a more credible policy.

The first section of this article examines the history leading up to Mexico's recent economic policies. Next, the article discusses Mexico's economic reform policies and how they have changed since the economic crisis began. The following section examines the factors that influence the credibility of Mexico's open market policies. The final section summarizes the likely trend in Mexico's policies.

The historical context

The years of inward orientation. The economic reform policies that Mexico undertook in the mid-1980s were a shift away from policies that began shortly after World War II. Like many developing countries in the early 1950s, Mexico pursued an *import-substitution industrialization policy.*[2] The government kept Mexican markets relatively closed to foreign competition, restricted foreign direct investment, and tightly regulated domestic financial markets.

The original impetus for closed market policies was the *dependency theory*, the idea that if poor countries want to grow, they have to break away from developed countries. Poor countries would have to start producing manufactured goods for themselves rather than continue to import these goods from developed countries in exchange for exports of primary goods. The fear was that poor countries would never catch up to the rich countries without major government intervention to manage international competition and support domestic industry.[3]

Despite the inherent problems of a closed, highly regulated economy, Mexico's real GDP per capita grew at an average annual rate of about 3.7 percent from 1954 to 1972 (*Figure 1*). Mexico did not grow as quickly as some other developing countries that followed more outward-oriented policies, such as Korea and Taiwan, but growth was stable and living standards were rising.[4] This period of Mexico's development has been referred to as *stabilizing development.*

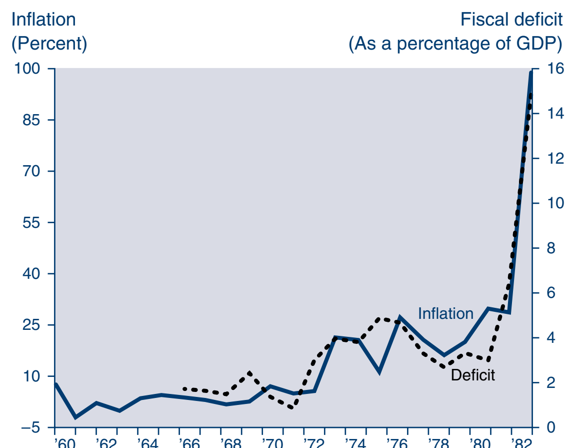
Table 1
Mexican Economic Indicators, 1954–72 and 1973–76

	1954–72 (Percent)	1973–76 (Percent)
Real GDP per capita growth	3.7	3.1
Inflation	3.5	20.1
Public deficit/GDP	1.8	4.3
Current account deficit/GDP	–1.5	–2.9

During the early 1970s, Mexico's inward-looking policies generated economic inefficiencies, but increased government spending during the period may have made these costs less apparent.[5] While per capita real GDP grew 3.7 percent from 1954 to 1972, it grew only slightly less, 3.1 percent, from 1973 to 1976. The microeconomic costs of price controls, a growing government sector, and inward-based industrialization policies were beginning to increase (Bazdresch and Levy 1991). Moreover, resources that might have otherwise been devoted to education and other productive investments were spent on subsidizing a growing number of the state-owned enterprises.[6] The world recession and the spike in oil prices that hit in 1973 only made matters worse for Mexico, which at the time was a net importer of oil (Lustig 1992).

In attempting to offset a slowdown in growth, Mexico pursed expansionary fiscal and monetary policies. However, as Table 1 and Figure 2 show,

Figure 2
Mexico's Inflation Rate and Fiscal Deficit, 1960–82



NOTE: Deficit data not available before 1966.

SOURCE: International Monetary Fund.

Table 2
Overview of Mexican Finances, 1954–94

Year	Population (In thousands)	Real GDP per capita (In U.S. dollars)	Real GDP per capita growth rate (Percent)	Inflation (Percent)	Nominal exchange rate (New pesos)	International reserves minus gold (Millions of U.S. dollars)
1954	31,419	2,397	7.15	4.85	.0125	147.08
1955	32,348	2,514	4.88	15.99	.0125	298.50
1956	33,483	2,590	3.02	4.85	.0125	344.50
1957	34,617	2,711	4.67	5.10	.0125	295.50
1958	35,757	2,751	1.48	8.17	.0125	247.50
1959	36,891	2,726	–.91	0	.0125	316.00
1960	38,227	2,836	4.04	7.59	.0125	306.00
1961	39,472	2,864	.99	–2.03	.0125	301.00
1962	40,754	2,897	1.15	2.15	.0125	333.00
1963	42,074	3,019	4.21	–.11	.0125	409.00
1964	43,446	3,258	7.92	3.55	.0125	418.00
1965	44,337	3,351	2.85	4.50	.0125	379.50
1966	46,337	3,467	3.46	3.77	.0125	454.99
1967	47,868	3,582	3.32	3.05	.0125	420.00
1968	49,451	3,766	5.14	1.76	.0125	491.92
1969	51,081	3,846	2.12	2.60	.0125	493.39
1970	52,770	3,987	3.67	7.06	.0125	568.10
1971	51,982	4,213	5.67	4.95	.0125	752.09
1972	53,690	4,404	4.53	5.66	.0125	975.88
1973	55,429	4,609	4.65	21.35	.0125	1,160.21
1974	57,165	4,782	3.75	20.60	.0125	1,237.63
1975	58,876	4,928	3.05	11.31	.0125	1,383.46
1976	60,560	4,973	.91	27.20	.0200	1,188.00
1977	62,211	4,900	–1.47	20.67	.0227	1,648.90
1978	63,836	5,208	6.29	16.17	.0227	1,841.51
1979	65,445	5,621	7.93	20.04	.0228	2,071.71
1980	67,046	6,054	7.70	29.78	.0233	2,959.89
1981	68,637	6,467	6.82	28.68	.0262	4,074.36
1982	70,225	5,942	–8.12	98.87	.0965	833.89
1983	71,791	5,401	–9.10	80.77	.1439	3,912.92
1984	73,309	5,524	2.28	59.17	.1926	7,272.04
1985	74,766	5,621	1.76	63.74	.3717	4,906.40
1986	76,178	5,283	–6.01	105.75	.9235	5,669.82
1987	77,562	5,262	–.40	159.16	2.2097	12,464.08
1988	78,933	5,349	1.65	51.66	2.2810	5,278.68
1989	80,312	5,566	4.06	19.70	2.6410	6,329.10
1990	81,724	5,827	4.69	29.93	2.9454	9,862.90
1991	83,306	6,018	3.28	18.80	3.0710	17,725.52
1992	84,967	6,253	3.90	11.94	3.1154	18,941.96
1993	86,557	6,167	–1.38	8.01	3.1059	25,109.61
1994*	88,054	6,244	1.25	7.00	5.0800	6,148.00

*Estimate.

NOTE: Data are for the end of the period. Real GDP is shown in terms of 1985 U.S. dollars and is adjusted for differences in purchasing power (using an equivalent basket of goods) between the United States and Mexico.

SOURCES: International Monetary Fund International Financial Statistics; Penn World Table, Version 5.6, 1995; Banco de México.

expansionary policies without real fundamental economic change simply generated inflation and large fiscal and current account deficits. In 1976, a balance of payments crisis erupted and led to a 60-percent devaluation in the peso, which had been fixed at 12.50 old pesos per dollar since 1954 (*Table 2*).

If macroeconomic policies had been as stable as they were in the 1950s and 1960s, Mexico might have been able to avoid the balance of payments crisis in 1976, even without structural change. But Mexico's increasing economic inefficiencies would have necessitated, at some point, fundamental change.

Mexico was ready for structural change in 1976, but huge oil discoveries appeared to lift fiscal and foreign exchange constraints, at least for the foreseeable future. Rather than implement the needed but difficult structural reforms, the new administration of President José López Portillo, expecting uninterrupted oil revenues, set out on a massive fiscal expansion. Without tight budgetary constraints, the state devoted more and more resources to purchasing private-sector firms that were no longer economically viable, with the hope of maintaining employment (Bazdresch and Levy 1991, 249). From 1950 to 1970, the number of para-statal firms in Mexico remained below 300; twelve years later, state-owned firms numbered 1,155. In 1983, state-owned firms accounted for 18.5 percent of GDP and employed more than 10 percent of the population (Aspe 1993, 181). Firms owned by the government included businesses such as the national oil company (PEMEX), the airlines (Aeromexico and Mexicana), the national telephone company (TELMEX), sugar refineries, and hotels.

Mexico's economic boom turn to bust when oil prices began to fall and U.S. real interest rates began to rise in mid-1981. The fixed exchange rate became extremely overvalued as the economic fundamentals changed. Investors' fear of another balance of payments crisis and devaluation led to capital flight. The government tried to maintain the exchange rate as long as it could, but foreign reserves were dwindling rapidly. In 1982, the government devalued the currency by more than 260 percent, declared a temporary moratorium on debt payments, and forced the conversion of dollar-denominated bank deposits into pesos at an unfavorable, below-market exchange rate.

As the crisis worsened, the government responded by tightening its grip on the economy. Toward late 1982, all trade became regulated, full exchange controls on capital were adopted, and the Mexican banking system was nationalized. But more government intervention spooked the financial markets and only made matters worse. With the Mexican financial markets in disarray, a government fiscal crisis, and inflation pushing an annual rate of 100 percent, real per capita GDP declined 8.1 percent in 1982 and 9.1 percent in 1983.

Hindsight is always better than foresight. By 1982, it was obvious that Mexico should have pursued more market-based policies and limited foreign borrowing. However, with the price of oil increasing quite rapidly during the late 1970s, and expectations of further price increases (expectations that other countries shared as well), the pressing need for change was not apparent (Lustig 1992, 21).

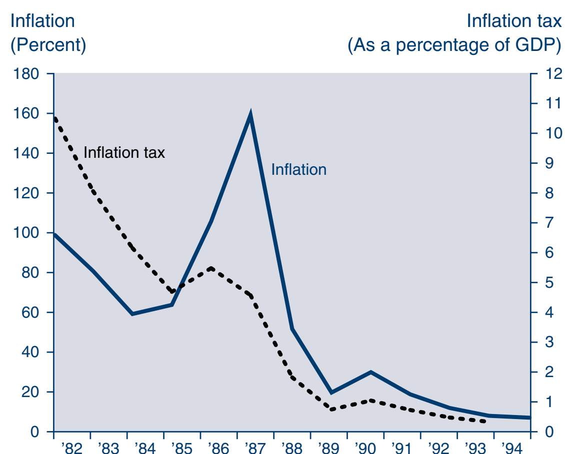
The transition years. In late 1982, Mexico's newly elected president, Miguel De la Madrid Hurtado, inherited perhaps the worst economic crisis in the country's history. During the early years of De la Madrid's administration, the first important stages of reform began, but it was only toward the end of his administration that structural reform policies genuinely moved in the direction of a more market-based economy.

From 1982 to 1985, Mexico's annual rate of inflation slowed from around 100 percent to about 65 percent in response to government spending cuts and tighter monetary policy. Real GDP per capita declined about 13 percent over these years as the economy adjusted to lower government spending and large foreign debt payments. Due to the high debt payments, Mexico's net transfers to the rest of the world totaled nearly 6 percent of GDP from 1982 to 1985 (Aspe 1993, 35).

Although the De la Madrid administration began reducing the public-sector deficit, it was not eliminating other fundamental causes of macroeconomic instability. Anti-inflation policies were not credible because the government still relied heavily on excessive money growth to earn inflation tax revenues. The inflation tax as a share of GDP was 8 percent in 1983 and 5.5 percent in 1985 (*Figure 3*).[7] The need for inflation tax revenues was due to debt payments, financial support of state-owned enterprises, and a weak tax system. Inflation began to accelerate in 1985, and by 1986, it was back up to more than 100 percent a year.

Although the economy was opening to trade, it was still relatively closed and the private sector was uncertain about the government's true

Figure 3
Mexico's Inflation Rate and Inflation Tax, 1982–94



SOURCE OF PRIMARY DATA: International Monetary Fund.

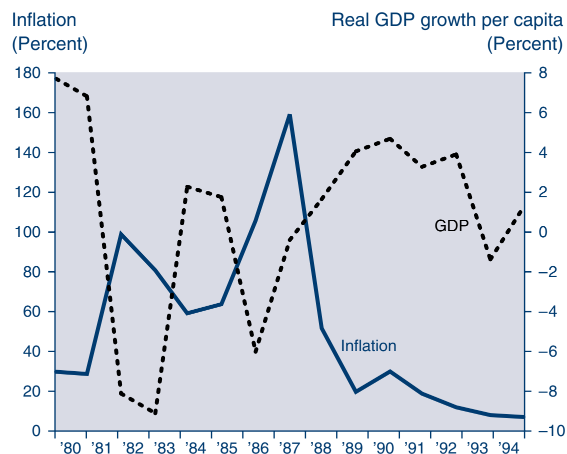
commitment to open markets. Thirty-five percent of imports had to be licensed, and quotas covered 83 percent of the value of imports (Aspe 1993, 156). The export sector was being held back because resources were kept in import-competing sectors. Foreign investment was also weak because investors were suspicious of Mexico's commitment to open markets; laws still limited foreign ownership of business, and the government controlled the banking sector. The macroeconomic environment continued to worsen. After an earthquake in 1985, another oil shock in 1986, and a stock market crash in 1987, Mexico was ready for rapid and far-reaching reforms. The next package of reforms began to address some of Mexico's worst structural problems.

The move to open market-based policies

During the early 1980s, Mexico's drop in real per capita income was almost as large as that which occurred during the Great Depression. As Figure 4 shows, in 1982 real per capita GDP fell 8.1 percent, while inflation rose to an annual rate of 98.9 percent. The experience convinced many people in and outside the government that Mexican policies were not working and they had to find an alternative (Aspe 1993, 14). Certainly, there were those, mainly in the protected and state-owned sectors, who resisted changes in policy. But as the economy continued to contract, their political clout waned. The country embarked on a new policy direction.

In December 1987, President De la Madrid and representatives of the labor, farming, and business sectors signed the Pact for Economic Solidarity, which was followed by the Pact for Stability and Economic Growth under the newly elected administration of President Salinas de Gortari. These two measures, now jointly referred to as the *Pacto*, were designed to combine orthodox fiscal and monetary restraint with structural reforms and an incomes policy (controls on wages and prices).

Figure 4
Real GDP Growth per Capita and Mexican Inflation, 1980–94



SOURCES: Penn World Table, Version 5.6, 1995; International Monetary Fund.

The Pacto has gone through 15 phases (or *renegotiations*, as they have been called) since its implementation in 1987.[8] The Pacto phases began as very short-term commitments, lasting about two months; they then grew to longer term, one-year commitments.[9] During the first phases, a strong emphasis was placed on price and wage controls, fiscal and macroeconomic adjustment, and debt renegotiation; later stages focused on deregulation and privatization to promote economic efficiency and on trade and financial liberalization to enhance competition and reduce production costs (Schwartz 1994).

Incomes policy. The incomes policy, or price and wage controls, has been and remains the most controversial part of the Pacto. Wage controls included programs that simply limited nominal wage increases, as well as more complicated schemes of linking nominal wage increases to productivity growth. Price controls were not uniform across the economy; the intention was to focus the controls on the leading sectors. Some have contended that the incomes policy was necessary to break the cycle of increasing inflation resulting from the practice of indexing wages and prices to past inflation (Lustig 1992, 52). Others, however, have argued that the incomes policy was unnecessary because, without fiscal and monetary austerity, the lifting of price controls would simply result in a return to high inflation.

Fiscal and monetary austerity are sufficient to stop inflation, but some have claimed that a benefit of the incomes policy was that it served to announce the government's intentions to all concerned parties. An explicit statement of the government's goals may have informed individuals what the inflation targets were, which could have decreased the costs of adjustment. However, price and wage controls, by themselves, can be costly because they tend to distort relative prices in an economy. The exact cost or benefit of Mexico's incomes policy has yet to be quantified.

The incomes policy was the most hotly debated during the first few months of the Pacto, when prices and wages were adjusted on a monthly basis according to changes in expected inflation. As inflation subsided, price and wage controls became a less contentious policy. High

inflation expectations were no longer automatically built into wage contracts, and the strength of labor unions to negotiate large wage increases declined. Although the December 1994 exchange rate devaluation was followed by higher inflation and attempts to impose more stringent price and wage controls, the government subsequently abandoned further attempts to impose controls.[10]

Public finance. An important element of the Pacto has been public finance policy. In addition to fiscal austerity, there has been a realignment of public-sector goods prices to reflect costs, the divestiture of state-run enterprises, and changes in the tax structure. An often observed difficulty with plans to reduce fiscal deficits, not just in Mexico but also in other countries undergoing economic reforms, is their structural inconsistency with other objectives. In other words, a government may state that the fiscal budget will be balanced and inflation will be reduced, but without a functioning tax system, inflation may be the only way to finance public expenditure. Although Mexico still has fiscal problems, changes in the public sector have made fiscal prudence a more feasible policy than during the early 1980s.

Of the 1,155 enterprises held by the public sector in 1982, 940 were either sold to the private sector, liquidated, or merged by 1994. State-owned enterprise expenditures fell from around 18 percent of GDP in 1983 to 9.6 percent of GDP in 1994. The recent economic stabilization plan for Mexico calls for further privatization of ports, public utilities, and some petrochemical plants. However, some of these proposed privatizations are being contested, and PEMEX, the national oil company and the largest state-run business, is not currently being considered for privatization.

Since 1989, the tax system has been simplified, and tax rates are down to levels similar to those in the United States. The corporate tax rate was reduced from 42 percent to 35 percent, and the highest income tax rate paid by individuals fell from 50 percent to 35 percent. By simplifying the tax structure, lowering tax rates, and increasing enforcement, tax evasion has fallen and tax revenue has increased. In the early 1990s, tax revenues increased nearly 30 percent, mostly as a result of Mexico's expanding tax base (Aspe 1993, 108). The overall fiscal deficit as a percentage of GDP fell from 16 percent in 1987 to 0.3 percent in 1994.[11] During the same period, total government spending fell from 43.7 percent of GDP to 26.3 percent of GDP, and inflation fell from 160 percent a year to 7 percent a year.

Mexico's stabilization plan of March 9, 1995, calls for increases in the prices of fuel, electricity, natural gas, and other goods and services provided by the public sector to reflect international prices and increase revenues. There are also plans to raise the value-added tax from 10 to 15 percent, reduce public-sector employment, and limit the growth of public-sector real wages.

Financial liberalization. An important element of Mexico's new reform policies has been financial liberalization. Financial liberalization took a major step forward after 1988 with the elimination of compulsory bank reserve requirements and forced credit to public-sector enterprises. The elimination of these measures allowed greater financing for private-sector enterprises. Other changes have been the authorization of universal banking and other financial entities. In 1991–92, the government privatized all the banks and lifted capital controls imposed after the 1982 crisis.

Mexico is now increasing access to foreign banks and brokerage houses. In October 1994, Mexico authorized virtually all the foreign banks, brokerages, and insurance companies that sought entry into the market. The finance ministry issued fifty-two licenses to eighteen commercial banks, sixteen securities firms, twelve insurance companies, five financial groups, and a leasing company.

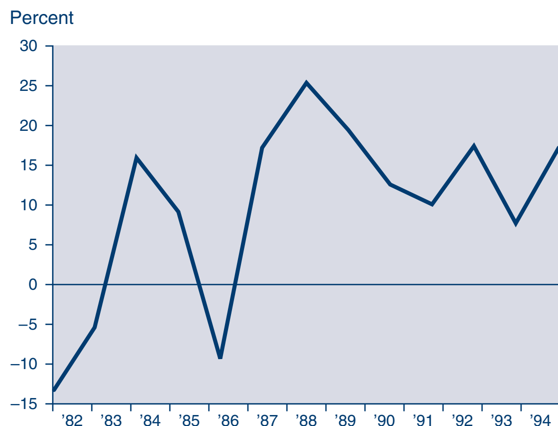
Because of the recent economic crisis and stress on the banking system, the government has pledged to speed up implementation of provisions that would allow greater foreign ownership of existing financial institutions. Foreigners will be able to hold majority interests in all but the three largest banks. Before the recent economic crisis, foreign ownership of existing banks was severely limited, although the banking sector still faced increased competition in the market. In 1991, Mexico's three largest banks—Banamex, Bancomer, and Serfin—accounted for about 62 percent of total Mexican banking assets; in late 1994, they accounted for less than 50 percent.

Since the December 1994 devaluation, there has also been an easing of the rules keeping financial institutions from using the futures market to hedge uncertainty. Prior to the devaluation, the development of a futures market to hedge peso and equity volatility was suppressed. But although the government felt that these markets would add to unwanted speculation against the currency, the markets may have led to greater flows of trade and investment. The rules now allow for Mexican institutions to hedge movements in the peso and the stock market.

Trade liberalization. On the trade side, Mexico started to gradually liberalize in mid-1985, but the process was solidified in 1988 when the number of goods covered by import licenses fell dramatically and the tariff structure was simplified. In

Figure 5

Annual Growth Rate of Trade (Exports Plus Imports) Between the United States And Mexico, 1982–94



NOTE: 1994 data annualized from first- and second-quarter data

SOURCE: International Monetary Fund.

1983, the share of imports covered by import permits was close to 100 percent; by 1992, the share had fallen to less than 2 percent (Banco de México 1993). Mexico joined the General Agreement on Tariffs and Trade (GATT) in 1986 and cemented its open trade stance with the United States and Canada through NAFTA in 1993. NAFTA has generated a large increase in trade and joint business ventures between U.S. and Mexican firms. For example, total trade flows between the United States and Mexico (exports plus imports) grew by around 17 percent in 1994, compared with a 7-percent annual rate in 1993. These trade flows have averaged about 15-percent growth since 1988 (*Figure 5*). Mexico is now vying with Japan to be our second largest trading partner behind Canada.

Monetary and exchange rate policy. When Mexico began its economic reform, the key element of its monetary policy was the use of the exchange rate as a nominal anchor—that is, domestic prices were tethered to international prices by targeting the nominal exchange rate. During the initial stages of the Pacto, the exchange rate was fixed to the dollar; then it was held to a preannounced daily depreciation. In 1991, the exchange rate was allowed to float within a widening band. At first, the top of the band rose 20 centavos (0.0002 new pesos) per dollar a day; then it was increased to 40 centavos (0.0004 new pesos) per dollar a day (*Figure 6*). On December 20, 1994, however, under pressure from foreign exchange markets and dwindling foreign exchange reserves, Mexico abandoned its exchange rate band. The peso was devalued and then allowed to float freely against the dollar.

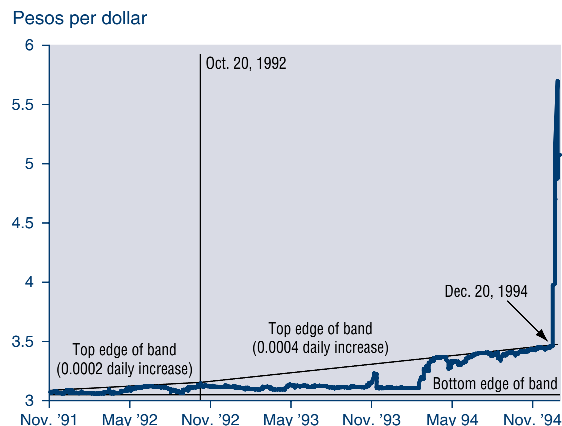
Some have argued that keeping the exchange rate closely tied to the dollar, especially during the early stages of Mexico's economic reforms, kept exchange rate volatility low and allowed investors a simple means of monitoring Mexico's monetary policy. For example, if expected inflation was higher in Mexico than in the United States or prospects for growth in Mexico weakened relative to those in the United States, dollars would leave Mexico seeking better returns in the United States. This would lead to upward pressure on the exchange rate (increase the number of pesos per dollar) as people who hold pesos buy U.S. dollars. If the exchange rate was to be kept within the band, Mexico would need to tighten monetary policy and increase interest rates to attract dollars back into Mexico. As long as the exchange rate policy was maintained and was credible, it was argued, anyone who watched the movement of foreign reserves would know what would happen to monetary policy.

Of course, exchange rate policy does not make low inflation credible. Low inflation is made credible only through sustainable fiscal balances and low and stable monetary growth. Over the long run, it is these policies that keep exchange rate policy credible, not the other way around. If monetary policy is too loose and is inconsistent with maintaining the exchange rate, foreign reserves leave the country. Without any foreign reserves to defend the exchange rate, the exchange rate policy has to be abandoned.

From 1987 to the end of 1993, Mexico's monetary policy was consistent with low inflation and maintaining its exchange rate targets. Inflation fell from a high of nearly 160 percent in 1987 to around 7 percent in 1994. During 1994, however, political uncertainty in Mexico and rising

Figure 6

Peso–Dollar Exchange Rate



SOURCE: Banco de México.

interest rates in the United States began to drain Mexican foreign reserves. Investors were not being fully compensated for the greater perceived risks in the Mexican market so they took their money elsewhere. Money left the country because interest rates did not rise sufficiently. A contributing factor could have also been that peso risks were difficult to hedge against. The central bank was suppressing the peso futures market because it feared the market would allow for inordinate speculation against the currency. Foreign reserves fell from around $25 billion at the end of 1993 to about $16 billion in July 1994 (*Figure 7*).

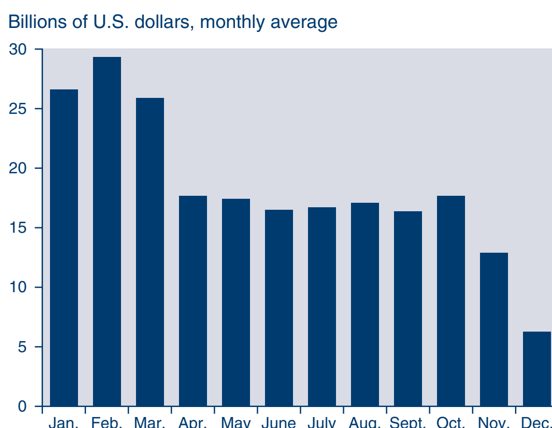
The election of Ernesto Zedillo in August 1994 brought new confidence in Mexico's policies and temporarily boosted foreign reserves and the peso. Following the elections, however, because of higher U.S. interest rates and increased investor uncertainty, money began flowing out of Mexico again. Without dramatically higher interest rates, foreign reserves continued to leave the country. Eventually, foreign reserves dwindled to such a point that the exchange rate band had to be loosened and then completely abandoned after continued pressure on the peso.

If interest rates had been kept higher after the 1994 presidential elections, perhaps the costs of abandoning the exchange rate, in terms of lost credibility and higher short-run inflation, could have been avoided. In hindsight, this may have been a better option than the one chosen, although dramatically higher interest rates could have also sparked an economic crisis. Perhaps a better option would have been to let the exchange rate float when foreign reserves were coming into the country, such as in late 1993. A floating exchange rate allows a country to weather domestic and international economic shocks without necessitating dramatic changes in domestic monetary policy and without calling into question the credibility of basic policies. Now that Mexico is floating its exchange rate, economic ups and downs will not generate speculation against a particular exchange rate policy. If monetary restraint continues, inflation—over the long run—will remain moderate.

Assessing Mexico's policy credibility

What determines credibility. Perhaps economic liberalization never comes without a crisis. This has certainly been the case in Mexico. What becomes evident from looking across a broad spectrum of countries that have embarked on economic reform is that some have achieved great success, while others have failed miserably.[12]

Figure 7
Mexico's Stock of International Reserves Less Gold, 1994



SOURCE: International Monetary Fund.

For example, Peru's trade liberalization attempt during the early 1980s was abandoned shortly after it was implemented. Will Mexico's economic reforms continue?

A common element of unsuccessful liberalizations seems to be the failure to create a credible economic policy. An example would be a government's pursuit of low inflation without addressing far-reaching structural problems, such as an inadequate tax system and a large budget deficit. In this case, pursuit of low inflation is inconsistent with the budget deficit and an inability to tax except through inflation.

Another credibility problem occurs when a government's policies are time-inconsistent. A time-inconsistent policy is one in which the government, at some later date, has an incentive to break it's promise. For example, the government, for political reasons, may have an incentive to redistribute income from the rich to the poor.[13] Under this objective, a free trade policy may not be credible because the government has an incentive to provide more protection than expected to import-competing firms whenever the relative price of imports decreases. When the price of imports falls, the import-competing sector becomes relatively poor; consequently, the government has an incentive to renege on its free trade promise and redistribute income through protection to these sectors. Free trade, then, is not a credible policy because the private sector understands the government incentive structure.

Creating a credible policy that is time-consistent can be problematic because it depends on the government's ability to precommit to a particular policy. In trade reform, for example, if a government cannot precommit to free trade, it may have to pursue a time-consistent but second-

best policy of partial tariff protection. In other words, the government may never be able to create a credible policy committed to complete free trade; it may, however, be able to create a credible policy with less protection.

Consequently, to evaluate the credibility of any particular economic policy two questions have to be addressed: (1) Is the policy consistent with other objectives being pursued at the same time? and (2) Is the policy time-consistent? In other words, does the government have an incentive to renege on the policy commitment? In the political economy context, the second question can be thought of addressing whether the political forces that determine a particular policy are likely to change.

Almost universally, no policy—whether in a developed country like the United States or developing country like Mexico—is completely credible. The lack of information about the government's incentives and uncertainty about future economic shocks makes complete credibility impossible. However, the degree of policy credibility can be subjectively assessed by examining factors such as the government's behavior over time, the country's institutions, and the consistency of policies.

Assessing the credibility of Mexico's economic liberalization. Since the December 1994 devaluation, Mexico's economic growth has stalled, and a growing number of people have become disenchanted with the current economic situation.[14] High interest rates have made it difficult for people to service their debts and have caused a decline in spending. While the economic crisis could generate a political stimulus for greater economic liberalization and macroeconomic stability, it could also cause the abandonment of policies that enhance long-run growth in order to ease the short-run pains of adjustment. So far, the policies that have been adopted since the crisis began have favored greater economic liberalization and long-run macroeconomic stability, but their credibility over time will be determined by their consistency with other objectives and the strength of the constituency groups that favor such policies.

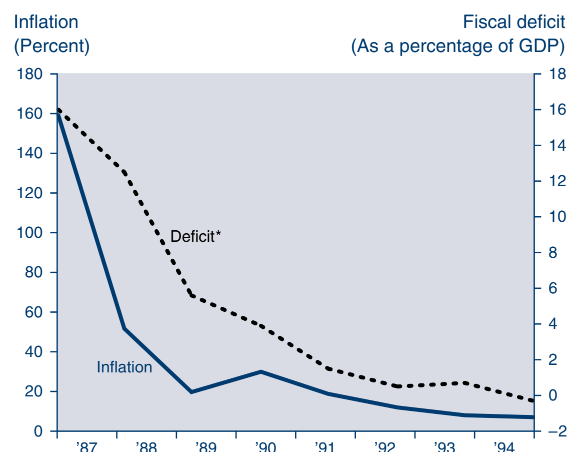
Because of Mexico's recent exchange rate devaluation, the credibility of another fixed exchange rate policy in Mexico is obviously very low. Mexico's past monetary policy, although it generated a relatively low rate of inflation, was not consistent with its rigid exchange rate band. Its current floating exchange rate regime, however, is more credible because it does not require any specific commitment to tie Mexico's monetary policy to that of the United States. In addition, while a floating exchange rate may be more volatile on a day-to-day basis, it is unlikely to experience the kind of large discrete jump that is often seen in managed exchange rate regimes.

Compared with the period after the 1982 crisis and devaluation, however, Mexico may have a more credible low inflation policy. Although inflation has dramatically increased since the December 1994 devaluation, over the longer run Mexico may be in a better position to avoid high inflation. Unlike the situation during the 1982 economic crisis, the Mexican economy now has fewer government-owned enterprises that are taking funds from the public sector; many of these businesses have been privatized or liquidated. Moreover, the government budget is not in a large deficit, and because of a better tax system, the government does not have to rely solely on the inflation tax (printing money to pay for government expenses) to collect revenues (*Figures 3 and 8*).

Government incentives to maintain a more stable macroeconomic environment may also be higher today than in the past. Unlike the early 1980s, economic interdependence is much more important in Mexico today. Trade as a share of GDP increased from 8.7 percent in 1982 to 22.1 percent in 1993. The benefits of foreign investment and its sensitivity to bad policy choices have also become more obvious over the last decade. Countries that are more open and outward oriented—such as Chile, Hong Kong, Korea, Singapore, and Taiwan—have achieved much higher sustained economic growth than more closed, inward-oriented economies.[15]

Figure 8

Mexico's Inflation Rate and Fiscal Deficit, 1987–94



* Public-sector borrowing requirements.

SOURCES: Banco de México (1994); International Monetary Fund.

The importance of market-based policies is apparent in Mexico's own experience. As discussed earlier, import-substitution industrialization policies were very costly for Mexico in terms of diminished economic efficiency and long-run growth. Moreover, while Mexico's 1982 crisis certainly hurt the country terribly, the poor policy response afterward, such as the nationalization of the banking industry, turned a bad situation worse by creating a massive capital flight for which Mexico paid a tremendous price. Despite the recent exchange rate crisis, Mexico has yet to reverse its open market stance.

Institutional arrangements can also increase the credibility of a policy. Although Mexico unilaterally reduced trade barriers in several areas before joining NAFTA and GATT, these multilateral agreements may be a much stronger commitment to future open markets, and not just because they are international agreements.

Free trade agreements create domestic coalitions against increases in domestic protection because of the threat of retaliatory response and possible collapse of the entire agreement. The greater the move to free trade, the more at stake and the greater the strength of these free trade coalitions. Usually, it does not pay for any one group to lobby against a single protective policy if the costs of such a policy to that group are relatively small. However, with NAFTA, a Mexican exporter has much more of an incentive to lobby actively against increases in Mexican protection because an increase in protection could induce a retaliatory response against its own products from the United States or Canada. The Mexican consumer also has a stake in seeing that the free trade agreement is kept because of the potentially large increase in the price of consumer goods if NAFTA is abandoned.[16]

Even though there may be coalitions in favor of sustaining open markets, in some sectors there is likely to be backsliding. Like the United States, Mexico is now using antidumping and countervailing duties against imports much more than in the past. Despite the fact that average tariff rates fell from around 34 percent in 1985 to 4 percent in 1992, the coverage of nontariff barriers went from 12.7 percent of imports in 1985–87 to 20 percent of imports in 1991–92 (Edwards 1993). The devaluation of the peso, however, may weaken the demand for nontariff barriers in Mexico. As the real value of the peso (adjusted for Mexican and U.S. inflation rates) has fallen against the dollar, the price pressure on import-competing firms in Mexico has decreased.

Conclusion

While continued economic reforms are not guaranteed in Mexico, they are more likely than is often believed. During the 1980s, Mexico's economic paradigm shifted from a closed market, inward-looking development strategy to an open market, outward-oriented development strategy. Unlike the period prior to Mexico's 1982 debt crisis, the trend in Mexico's economic policies has been toward greater economic integration in the world economy and a reduced reliance on the government sector. This trend in Mexico's policies, although not immune to shocks, is more consistent with future low inflation and greater economic growth than the country's previous inward-oriented policies.

Notes

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1 In December 1994, the Blue Chip consensus forecast for 1995 Mexican real GDP growth was 3.8 percent. The OECD was predicting 4-percent growth for 1995 and 4.3-percent growth for 1996.

2 One of the main architects of this policy was Raúl Prebisch. For an insightful analysis of Prebisch's views, see Love (1980).

3 The underpinnings of this theory was the idea that as world income rose, the demand for manufactured products would increase relative to primary products, and this change would lead to a lower relative price for primary products in international markets. As a result, if developing countries did nothing to change the structure of their output, their terms of trade would always move against them.

4 Over the same period, Taiwan and Korea both experienced around 4.6-percent real GDP growth per capita.

5 Although Prebisch was one of the main architects of the import-substitution industrialization policy, he realized the problems of protectionism as early as 1963. Hirschman (1968) quotes a very interesting passage from Prebisch (1963, 71): "As is well known, the proliferation of industries of every kind in a closed market has deprived the Latin American countries of the advantages of specialization and economies of scale, and owing to the protection afforded by excessive tariff duties and restrictions, a healthy form of internal competition has failed to develop, to the detriment of efficient production."

6 Gil Díaz (1984). As price controls were imposed to limit inflation, the profit margins of some private firms were squeezed. Those firms that could no longer produce profitably at the given prices were then purchased by the government. This was the case, for example, with sugar mills.

[7] The real output that a government obtains by printing money and spending it is called the inflation tax or seigniorage. Money creation that leads to inflation erodes the real value of nominal money holdings. The formula used here to calculate the inflation tax as a share of GDP is: $INFTAX = (M/GDP) * \pi/(\pi + 1)$, where M is monetary base, GDP is nominal gross domestic product, and π is the annual inflation rate.

[8] If one includes the two stabilization plans announced on January 2, 1995, and March 9, 1995, as new Pacto phases, then there have been seventeen phases.

[9] See Schwartz (1994) for the dates of Pacto announcements and phase durations.

[10] The Mexican government's first stabilization plan, announced on January 2, 1995, allowed for a 7-percent increase in overall wages. On March 9, a revised plan included an additional 10-percent increase in the minimum wage, but those earning more than the minimum wage were free to negotiate their own wages.

[11] The overall fiscal balance referred to here is the public-sector borrowing requirement, which measures the difference between total revenue and expenditure, which includes debt amortization in the interest component. The primary balance, which excludes all of the interest component in expenditures, has been in surplus since 1985.

[12] See Michaely, Papageorgiou, and Choksi (1991) for an overview of the liberalization experience in several developing countries.

[13] This is a case analyzed by Staiger and Tabellini (1987). In formal economic terms, the government's objective is to redistribute income from individuals with a low marginal utility of income to those with a high marginal utility of income.

[14] Recent election results suggest such disenchantment. For the first time in its sixty-five year history, the ruling Institutional Revolutionary Party (PRI) lost the governorship in the state of Jalisco, which includes Mexico's second largest city, Guadalajara. The victory went to the National Action Party (PAN), which received 55 percent of the vote.

[15] See Gould and Ruffin (forthcoming).

[16] See Gould (1992) for a more in-depth discussion of this topic.

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